June 2016

# "The General Theory of Second Best" - An Overview

Robert Ashford

# "THE GENERAL THEORY OF SECOND BEST"—AN OVERVIEW

*Robert Ashford*[*]

The following essay by Professor Richard Markovits provides a rigorous discussion of the "General Theory of Second Best."[1] The General Theory of Second Best has received scant attention in the field of law and economics. This is regrettable because its implications present a fundamental theoretical challenge to much mainstream "law and economics" and can produce important practical consequences depending on real-world market conditions, which (as contrasted with hypothetical perfectly efficient market conditions that economic analysis too frequently assumes) are always a matter of primary concern to socio-economists.

One can understand the General Theory of Second Best by considering the concept of allocative efficiency. In the hypothetical world of perfect competition, markets reach an equilibrium in which resources are allocated in a way that the production (i.e., supply) of all goods (including services) is offered and sold according to the market demand for them. (Depicted graphically, allocative efficiency is achieved where demand curves [generally downward sloping to reflect the expected decrease in demand in response to rising prices] and supply curves [generally upward sloping to reflect the related expected increase in production also in response to rising prices] intersect.). Demand indicates the value attributed to the good by buyers, and supply indicates

* Robert Ashford is Professor of Law at Syracuse University, College of Law, where he teaches or has taught courses in Business Associations, Business Planning, Public Corporations, Professional Responsibility, Secured Transactions, Securities Regulation, and a seminar in Inclusive Capitalism, Property Rights, and Binary Economics. He holds a J.D. with honors from Harvard Law School and a B.A. with majors in physics and English literature, graduating first in his class at the University of South Florida. He was a Woodrow Wilson Fellow at Stanford University. He is a leading authority in socio-economics and binary economics.

1. Richard S. Markovits, *The General Theory of Second Best and Economic-Efficiency Analysis: The Theory, its Negative Corollaries, the Appropriate Response to It, and a Coda on the Economic Efficiency of Reducing Poverty and Income/Wealth Inequality*, 49 AKRON L. REV. 467 (2016).

the cost of production in terms of resources used that could be used to produce other goods. In other words, we should see items produced, or services provided, only when the price consumers are willing and able to pay exceeds the cost of production, including the opportunity cost incurred by not directing the utilized resources to another project.

Presumably, the efficient amount of inputs is drawn into the production of the good at the level of output determined by demand (measured by buying power) and supply (reflected by the inclusion of all costs of production). As a general matter, it is most efficient for consumers to purchase in markets in which all costs of production (as a measure of resources used up) are minimized by perfect competition. Given the state of productive capacity of an economy, available resources will be efficiently allocated so that the production of goods will be maximized to satisfy consumer demand.

However, as indicated above, one of the requirements for markets to work efficiently is for *all* costs of production to be internalized. Unless they are, the prices charged will be artificially low because they do not include all the inputs used. Instead they reflect only the costs of the inputs a firm was required to pay for (or "internalize"). Typical costs that are not internalized include harms resulting from things ranging from air and water pollution and other environmental degradation to careless behavior and even a contract breach for which the breaching party is not held accountable.

Subject to a few exceptions, internalizing all costs of production is an important step toward allocative efficiency and efficient levels of output. So now consider freight being carried by trucks and freight carried by railroads. Each causes some damage. The trucks tend to make driving more dangerous for other drivers, passengers, and pedestrians. The trains, on the other hand, are noisy and decrease the value of surrounding property values. Also assume that both modes of shipment charge the same price and divide the market evenly. Now in response to complaint, the legislature passes a law that makes it easier for injured property owners to recover from the railroads for the reduction in their property values. Consequently, railroads must pay for more of the damage they cause and the price and cost of railroad freight shipment go up. Considered in isolation, the effect of trucking on the economy will enhance allocative efficiency and lead to a more efficient level of output. At the same time, recovery for claims by injured motorists remains unchanged so that the price of shipping by truck remains the same because no additional costs of the accidents they cause are internalized by the truckers. Train and truck shipment are substitute products. The

increase in the price of train shipment will cause the demand for truck shipment to go up because truck shipment has become relatively less expensive. An increase in demand means an increase in truck shipment output and even more damages to motorists, passengers, and pedestrians that are not reflected in truck shipment costs. Moreover if per unit of output, trucking costs and prices decline by reason of economies of scale, even more shipping will shift from trains to trucks. The net effect is that pushing train usage toward allocatively efficient levels by internalizing damages to property owners may lead not only to more injury to motorists, passengers, and pedestrians (along with less damage to property owners), but also (1) greater damages (in monetary terms) from trucks than the reduction in monetary damage to land owners and (2) truck shipment prices that are even more distorted. In fact, unless one can generate a second, regrettably-complicated argument to the contrary (which will require both a theoretical and an empirical component), there will be no reason to believe that internalizing the externalities that trains generate in an economy in which trucks will continue to generate externalities will be more likely to improve outcomes than to worsen outcomes from the perspective of economic efficiency.

Standard, "first best" economic-efficiency analyses ignore this reality. These "first best" analyses generate conclusions based on the assumption that, even in a world that will contain economic imperfections regardless of which policy-choice is made, policies that reduce the number or magnitude of the imperfections in an economy will *always* increase economic efficiency on that account. That assumption is false. The General Theory of Second Best explains why conclusions that derive from that assumption are no more likely to be right than wrong—namely, because, in general, the imperfections that the policymaker can eliminate or reduce are as likely to compound as to counteract the distorting effects of the imperfections that remain. More positively, the General Theory of Second Best can provide the basis for an economically efficient economic-efficiency-analysis protocol—a protocol for predicting whether in the circumstances in question a policy that would decrease (or, for that matter, would increase) the number and magnitude of an economy's economic imperfections to specified extents will increase (or decrease) overall economic efficiency on that account.

The following essay on the General Theory of Second Best will be difficult reading for people with little or no economic training, and simultaneously a serious challenge for more economically sophisticated readers. Its author, Professor Richard Markovits, is an internationally recognized expert in this field. The essay is included in this Symposium

as testimony to the proposition that good socio-economics requires good economics and evidence of the economic rigor that socio-economics brings to economic analysis.